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The Financial System and Public Enterprise Reform

Concepts and Cases

Aslı Demirgüç-Kunt
Ross Levine

Public enterprise reform is more successful in countries whose financial systems are relatively well developed. Countries seeking to implement broad public enterprise reforms achieve greater success if they also implement substantial and well-designed financial reforms.

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Summary findings

Public enterprise reform is an important part of policy strategies to accelerate economic growth in many countries. Demirgüç-Kunt and Levine identify two distinct but complementary approaches to public enterprise reform: the private sector development approach and the corporatization approach.

The private sector development approach involves privatizing public enterprises and encouraging private sector development to improve economic efficiency and shrink the relative size of the public sector.

The corporatization approach involves improving managerial incentives and clarifying budget constraints on public enterprises, so their performance improves without the government relinquishing ownership.

Demirgüç-Kunt and Levine study the relationship between the financial system and public enterprise reform. Their conceptual framework describes the role of three financial services — mobilizing resources, evaluating firms, and monitoring managers — in promoting both the private sector development and corporatization approaches to reform.

Using nine country case studies (of Chile, Egypt, Ghana, India, Mexico, the Philippines, the Republic of Korea, Senegal, and Turkey), they study the links between public enterprise reform and both financial sector reform and the initial state of the financial system. They reach three broad, tentative conclusions:

- Public enterprise reform is more successful in countries whose financial systems are relatively well developed and less successful in countries with relatively underdeveloped financial systems.
- Countries will be more successful in implementing large-scale public enterprise reform if they also implement substantial, well-designed financial sector reform.
- Successful reform of the financial sector generally involves implementing three components in the following order: building financial infrastructure, liberalizing the sector, and expanding the number of private financial intermediaries (removing impediments to the expansion of private intermediaries, downsizing public banks, and privatizing some public banks). Failure to implement any of these components severely jeopardizes the chance that financial reform will support public enterprise reform.

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Concepts and Cases

Aslı Demirgüç-Kunt and Ross Levine

Finance and Private Sector Development Division
Policy and Research Department
The World Bank

We received very helpful comments from Gerard Caprio, Ahmed Galal, Michael Gavin, Bharat Nauriyal, Steve Saeger, Hemant Shah, Mary Shirley, and Paulo Vieira Da Cunha.

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Aslı Demirgüç-Kunt and Ross Levine*

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I. Introduction and Qualifications

A. Summary

Public enterprise reform is an important component of policy strategies to accelerate economic growth in many countries. Public enterprise (PE) reform consists of two distinct, but complementary, approaches. The private sector development approach to PE reform involves privatizing PEs and encouraging private sector development to both enhance economic efficiency and shrink the relative size of the PE sector. The corporatization approach involves enhancing managerial incentives and clarifying PE budget constraints, so that PE performance improves without the government relinquishing ownership.

This paper studies the relationship between the financial system and the success of PE reforms. We first develop a conceptual framework that describes the role of three financial services - mobilizing resources, evaluating firms, and monitoring managers - in promoting both the private sector development and the corporatization approaches to PE reform. We then use nine country case studies - Chile, Egypt, Ghana, India, Korea, Mexico, the Philippines, Senegal, and Turkey - to study the linkages between PE reform and both the initial state of the financial system and financial sector reform.

Our analysis yields three broad, tentative conclusions:

(1) ***Countries with initially relatively well-developed financial systems enjoy comparatively more successful PE reforms than countries with comparatively underdeveloped financial systems.*** While an initially well-developed financial system is neither necessary nor sufficient for successful PE reform, well-developed capital markets substantially expand the set of feasible privatization options available

to the government, and well-functioning financial intermediaries enhance competition, improve resource allocation, and lower adjustment costs. Thus, market-oriented financial services bolster both the private sector development and corporatization approaches to PE reform.

(2) ***Countries seeking to implemented large-scale PE reforms achieve greater success if they also implement substantial and well-designed financial sector reforms.*** In many countries, a dual economic system exists, where public banks primarily serve PEs based on public-policy criteria and private financial intermediaries primarily serve private firms based on market criteria. Thus, to be successful, PE reform involving greater reliance on market-principles will, in almost all cases, require comprehensive financial sector reforms so that the financial system can provide market-based financial services.

There are two noteworthy corollaries to this hypothesis. First, in the presence of a relatively well-developed financial system, *moderate-scale public enterprise reform can succeed without substantial financial sector reforms*. Second, *poorly designed financial sector reforms can hurt public enterprise reform.*

(3) ***Successful financial sector reform involves three components that are generally implemented in the following order: financial infrastructure building, liberalization, and private financial intermediary expansion. Failure in any component severely jeopardizes the chance that financial reform will support PE reform.*** Countries with large PEs often have financial systems that do not and cannot provide market-oriented financial services. Thus, financial reforms will

typically be needed to create a financial system that can support PE reform. Financial infrastructure building involves improving the regulatory system, supervisory capacity, legal codes, and enforcement capabilities. Infrastructure improvement should facilitate financial contracting and improve the chances that private financial intermediaries will operate and compete prudently. Financial liberalization involves reducing interest rate controls, directed credit programs, taxation, and government oversight. Liberalization is designed to stimulate competition for savings, better resource allocation, and enhanced corporate governance. Finally, to support PE reforms, financial sector reforms should promote private financial intermediary development by removing impediments to private intermediary expansion, downsizing public banks, and privatizing some public banks.

An important corollary to this hypothesis involves the sequencing of PE reform and financial sector reform. Our analysis suggests that some financial sector reforms should proceed, others accompany, and still other reforms follow PE reform. Specifically, policy makers should begin financial liberalization and financial infrastructure building prior to PE privatization because financial reform is a long-run process and needs to be initiated early to create a solid foundation for PE reform and further financial reforms. During PE privatization, authorities should continue liberalizing and building a market-oriented financial infrastructure and also remove impediments to private financial intermediary development. Finally, governments should initiate the process of privatizing some state-owned banks along with and soon after PE privatization.

B. Qualifications and Cautions

These conclusions represent our best judgements after formulating a conceptual framework and reviewing nine country experiences. Here we qualify our findings and list a few reasons for being less than sanguine about our results.

B.1. Causality: The causal relationship between financial development and PE reform runs in both directions, and exogenous factors help determine the ultimate success of both PE and financial reform. While this paper argues that financial services promote successful PE reform, we readily acknowledge that public enterprise reform can stimulate increased demand for and improvements in capital market and financial intermediary services. The two reforms are inseparable. Indeed, PE reform and financial reform tend to be mutually reinforcing. This paper, however, focuses on the financial system and financial reform as inputs into public enterprise reform, and therefore, we do not give equal treatment to the role that public enterprise reform plays in stimulating financial sector improvements.

Furthermore, the causes of the ultimate success or failure of PE reform are probably based more in the political and social commitment to change than in the pre-existing state of the financial system. In many countries, technical mechanisms exist to reform PEs and improve the financial system; the missing ingredient is political and social commitment. Nevertheless, by highlighting the linkages between the financial system and PE reform, this paper seeks to ensure that, once the political will for change exists, PE reforms do not ignore financial factors that critically enhance the probability of successful PE reform.

B.2. Methodology: Two methodological issues should make readers cautious about this paper's conclusions. First, we examine only nine country cases. Many factors will influence PE reforms or whether governments even undertake reform. Macroeconomic conditions and the policy environment influence economic performance. Labor markets, product markets, politics, the trade regime, and the legal system all play important roles in PE reform. Thus, the explanatory variables probably outnumber the country cases. Instead of formal statistical support for our conclusions, we construct a conceptual framework and then evaluate whether, in general, the cases are consistent with this framework.

A second methodological problem is that we categorize PE reforms and financial systems broadly. We classify PE reform experiences as relatively successful or unsuccessful even though there are different criteria along to which to judge enterprise reform, and countries have different objectives. Similarly, economists differ in how to measure "financial development." Thus, classifying PE reform and financial systems involves great subjectivity. Nonetheless, we assess the comparative levels of financial development and the relative success of PE reform efforts, so that we can formulate views on the most important linkages between the financial system and PE reform.

With these qualifications and cautions in mind, Section II presents a conceptual approach to the linkages between PE reform and the financial sector. After briefly reviewing the nine country case studies in Section III, we evaluate the impact of the initial state of the financial system on PE reform in Section IV and the links between financial reform and PE reform in section V. Section VI presents policy recommendations.

II. Concepts

A. Overview and Definitions

This section describes three services - mobilizing savings, allocating capital, and monitoring managers - that are crucial determinants of enterprise efficiency and economic growth.[1] In many countries, the financial system plays an important role in mobilizing and allocating capital, and in overseeing managers. Consequently, analysts frequently call these three services "financial services" or "functions of the financial system." We follow this custom. Nevertheless, it is important to recognize that governments and institutions not always labelled "financial institutions" sometimes provide these services, especially to public enterprises and in economies dominated by publicly owned enterprises.

To construct a conceptual framework of the role of the financial system in PE reform, we first describe the role of the financial system in a hypothetical economy where the government plays very little role in mobilizing resources, selecting firms, providing corporate governance, or operating enterprises. In this type of environment, private financial institutions provide financial services to private enterprises. We then consider a country that chooses to have a large public enterprise sector. Countries that create public enterprises will also create institutions to finance PEs. Public banks are one popular vehicle for doing this. This perspective implies a dual economic system, where public banks primarily serve public enterprises based on public-policy criteria and private financial intermediaries primarily serve private firms based on market criteria.

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[1] See Caprio, et. al (1994) and King and Levine (1993a, 1993b).

We focus on two types of PE reform. The first type of reform, "PE reform with greater PE autonomy," involves reducing the role of government and state-controlled banks in mobilizing resources for enterprises and monitoring managers. Here, we focus on privatization; but we also discuss PE corporatization where PEs are treated more like private firms. The second type of PE reform that we consider consists of tighter government oversight of the PE. Here, the government monitors PE managers more rigorously and tightly imposes a budget constraint on PEs to improve performance.

We argue that PE reform involving greater PE autonomy will have a much better chance of increasing economic efficiency in the presence of an initially well-functioning, non-state dominated financial system. Privatization or PE corporatization with greater autonomy implies an increased reliance on market-based financial services. Since governments create state-controlled banks partly to serve PEs, state banks are generally less effective at providing market-based financial services than private financial intermediaries. Thus, PE reform involving greater PE autonomy will tend be more successful if undertaken in the presence of an initially well-developed private financial system.

Moreover, this conceptual framework also implies that PE reform is inextricably linked to financial reform. To the extent that the publicly-owned financial system has been established to serve PEs, reforming the PE sector will require different arrangements and institutions to provide essential financial services to reforming enterprises. To be successful, financial sector reforms should include (1) interest rate, tax, and directed credit liberalization so that emerging institutions can effectively mobilize savings, allocate capital, and oversee managers, (2) enhanced supervision and regulation to ensure a safe and competitive private financial system, and (3) rapid downsizing of public banks that serve PEs, typically including some public bank privatization. While public banks maybe able to serve private firms, the different incentives typically faced by private banks suggests that private intermediaries will more effectively promote PE privatization than public banks.

Accordingly, our conceptual framework suggests that PE reform must be coordinated with financial reform to be successful: large-scale PE privatization requires large-scale financial sector reforms; and, slower-paced or small-scale PE reform can succeed with more modest and moderately-paced financial reforms. Furthermore, well-functioning stock exchanges and financial institutions broaden the set of reform strategies available to policy makers by facilitating the ability of the government to privatize PEs. Thus, the functioning of the financial sector may importantly influence the PE reform strategy and the ultimate success of PE reform.[2]

Although PE reform involving tighter government oversight of PEs will rely less on the financial system than PE reform involving greater PE autonomy, the financial system may also indirectly promote PE reform based on tighter government oversight. Specifically, a well-functioning financial system boosts private sector development. Private sector development in turn promotes successful PE reform by augmenting competition and market-based incentives throughout the economy and by strengthening labor demand, which may fall as reforming PEs shed excess workers.

If a country is unable or unwilling to liberalize financial repression, upgrade its financial infrastructure, and privatize existing public banks, the country should adjust the

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[2] Although a strong financial system enhances the probability of successful PE reform, an under-developed financial system should not necessarily delay PE reform since financial sectors can be reformed and strengthened.

pace of public enterprise reform. Indeed, comprehensive reform of both PEs and banks may reflect the "true" underlying cause of successful PE reform: deep social and political commitments to changing the incentives and opportunities faced by businesses and individuals.

B. Financial Services in a Market Economy

To exemplify the importance of finance in PE reform, we first discuss the importance of three financial services in an economy where the government plays little direct role. We call this a "market-oriented" economy.

First, in market-oriented economies, the financial system evaluates firms and allocates resources based on these evaluations. Financial market participants research firms, managers, sectors, and business trends and choose the most promising and credit-worthy ventures. This includes large financial intermediaries such banks, mutual funds, pension funds, and insurance companies deciding where to make loans and purchase equity, but this also includes small venture capital institutions and individual entrepreneurs seeking profitable investments. Better financial systems are better at evaluating enterprises and allocating resources to firms with high expected returns. The better financial systems are at obtaining and processing information, the better will be the allocation of capital.

Second, financial systems mobilize capital from disparate savers through banks, insurance companies, pension funds, investment companies, and capital markets. This mobilization is critical for economic development. Many worthwhile investments require large capital inputs and some enjoy economies of scale. By agglomerating savings from many individuals, financial intermediaries enlarge the set of projects available to society.

Furthermore, financial systems that both effectively mobilize savings and select promising firms intensify competition. Currently dominant firms will be less protected from competition if sound financial systems are able to identify and fund competing enterprises.

Finally, financial systems help compel managers to act in the interests of firm claim holders (stock, bond, and debt holders). In large private enterprises with disperse claim holders, enterprise managers may enjoy excessive independence from enterprise managers. Small equity and bond holders may be unable or unwilling to obtain information, process that information, and effectively oversee the management of large, complex corporations. Managers, therefore, may funnel enterprise resources to themselves or make decisions based on personal as opposed to corporate criteria. The financial system may be able to improve corporate governance. Large financial intermediaries, with proper incentives and staff, will undertake the difficult tasks of monitoring managers and obliging them to act more in the interests of firm claim holders than a disparate group of individual shareholders (none of whom individually finds it worthwhile to undertake the large monitoring costs). This corporate governance will encourage more efficient resource allocation by aligning managerial incentives with those of creditors. In addition to improving resource allocation, good corporate governance encourages investment since investors will feel more confident that firms will maximize owner profits and service debt obligations. Thus, in market-oriented economies, financial systems that ensure that managers act in the best interests of creditors foster superior resource allocation and more investment.

Sound capital markets can assist intermediaries in exerting corporate governance. If capital market participants competently obtain and process information, equity and bond prices will reflect managerial performance and thereby influence managerial behavior. Also, if capital markets effectively mobilize capital and identify inferior managers, capital markets offer motivated groups a vehicle for raising capital, acquiring firms, and changing management. Therefore, managers may feel more compelled to maximize the value of the enterprise to claim holders in the presence of well-functioning capital markets.

C. Finance and Public Enterprise Reform

We now describe when and how financial systems affect PE reform.

C.1. Public Enterprises, Public Banks, and Reform: To start, consider an economy with a large PE sector. Further assume that the government exerts a strong hand in directing credit to favored PEs and has created public banks to facilitate the mobilization of resources for PEs based on public-policy considerations. In such an environment, state-controlled banks generally do not research firms carefully and allocate credit on market-criteria, nor will state-controlled banks necessarily compete aggressively to mobilize resources, and state-controlled banks will also not exert tight corporate governance to the same degree or in the same manner that private financial institutions monitor managers of private firms. Thus, in an environment where the government has historically guided credit allocation, the staff of state-controlled financial intermediaries may not be trained in acquiring and processing information on firms based on market-principles, assessing risk, attracting customers, and overseeing managers.

This lack of market-oriented financial skills may be complimented by a lack of financial and legal infrastructure. Pervasive government interference in financial markets will tend to reduce reliance on and therefore development of corporate financial reports and laws concerning collateral, information disclosure, and bankruptcy. This implies that countries with large PE sectors may have mechanisms for acquiring information and enforcing contracts that would not successfully support a large private enterprise sector. Furthermore, in countries where the government and state-controlled banks play a leading role in the financial sector, authorities do not have strong incentives to establish sound prudential rules and supervisory capabilities. This discussion suggests that countries with large PE sectors often have financial systems that cannot provide market-based financial services because the large PE sector stymies market-oriented financial development.

From the starting point of a country with a large PE sector and state-controlled banks, we now evaluate the role of the financial system and financial sector reform in promoting the success of three types of PE reform: privatization, corporatization involving greater PE autonomy, and corporatization involving tighter government oversight.

C.2. Privatization: Privatizing an enterprise typically signifies a much reduced role for the government in directing banks to fund PEs, providing guarantees on PE borrowing, or compelling banks to fund PEs at low interest rates. If the financial system is not ready to provide market-based financial services, significant financial reforms will have to be initiated for privatization to be successful. These financial reforms should include the following three components: (1) liberalization of interest rate controls, credit controls, and government repression of banks to stimulate greater and more effective competition of savings, better resource allocation, and enhanced corporate governance on market terms, (2) strengthening of the legal, regulatory and supervisory system: to ensure that private financial intermediaries operate and compete in a prudent fashion, and to facilitate financial contracting, (3) state-bank downsizing - typically including bank privatization - to increase the capabilities of the private financial sector.

The financial system also broadens the set of privatization options. First, well developed, liquid capital markets will make it easier to privatize PEs through the selling of equity to a broad group of investors. Broad distribution may mitigate criticisms that the government is selling public property cheaply to particular individuals for political or personal advantage or that the government is giving the country away to foreigners. Second, banks and other financial intermediaries may improve the privatization process. Banks that effectively mobilize savings, assess entrepreneurs, finance purchases of PEs and energetically and competently oversee new management will expand the number of investors that can participate in the privatization process, help ensure that PEs go to qualified owners, and compel new owners to act appropriately. Finally, a well-functioning financial system reduces the urgency for breaking up large firms prior to privatization to prevent the establishment of entrenched private monopolies. Specifically, some large PEs may have market power even though they are not natural monopolies. Under-developed financial markets make market entry more difficult and therefore may allow privatized enterprises with market power to remain relatively immune to competitive forces. On the other hand, a well-developed financial system would help subject even large firms to competition by strengthening the ability of new firms to bring better goods to market.

The financial system will also play an important role in reducing the adjustment costs of PE privatization and thereby enhance the political sustainability of PE reform.

Newly privatized firms that need to be reoriented and re-tooled will adjust and grow faster if financial markets can quickly allocate capital to promising firms and ensure that these funds are used well. Similarly, by efficiently redeploying the assets of bankrupt enterprises, a sound financial system will reduce adjustment costs. Furthermore, by accelerating private sector development, an effective financial system will indirectly increase labor demand and thereby mitigate concerns about unemployment. Since unemployment may be an important obstacle to beginning and maintaining PE reform, the financial system may pacify political pressures emanating from unemployment by boosting private sector labor demand and reducing adjustment costs. Thus, a well functioning financial system can reduce the severity and duration of any adjustment following PE privatization and maximize the private sector response. Table 1 summarizes this discussion by illustrating the dimensions along which the government and state-banks exert a reduced role in mobilizing, allocating, and governing privatized enterprises.

C.3. Corporatization with Greater Autonomy: The role of the financial system in corporatization can be evaluated along the same spectrum. Tautologically, corporatization strategies that involve more PE autonomy - defined as the government playing less of a role in defining and imposing a budget constraint, allocating resources, and monitoring PE managers - will have a better chance of improving enterprise performance in the presence of a well-developed financial system. When corporatization implies that PEs must go to financial markets and compete for financing with other public and private firms, a market-oriented financial system will oblige these newly corporatized firms to improve efficiency. For this type of corporatization strategy to succeed, banks must be sufficiently strong and independent to reject loan requests from PEs. Furthermore, banks that believe the government implicitly guarantees loans to PEs will funnel credit to PEs instead of more worthy firms. If financial systems continue to allocate credit to corporatized firms on non-market terms, PE reform will not cultivate efficiency improvements as rapidly. Similarly, corporatization that involves less government oversight of management may prove disastrous - and certainly unsustainable - unless the financial system can effectively exert sound corporate governance. Put simply, corporatization that involves a reduced government role in financing PEs and overseeing managers will be more successful in the presence of a financial system that can provide these services.

C.4. Corporatization with Greater Government Oversight: Corporatization, however, may not involve expanded PE autonomy. Corporatization may consist of more rigid government control of the PE. Governments may impose tight budget constraints and explicitly limit PE access to bank credit in order to harden incentives to improve PE performance. Corporatization that involves tighter control of PEs by the government will rely less on an independent financial system than corporatization with expanded PE autonomy or privatization. Nonetheless, a well-developed financial system may indirectly promote all categories of PE corporatization by promoting private sector development. Private sector development, in turn, promotes corporatization by intensifying competitive pressures on PEs, intensifying incentives for PE managers to improve enterprise efficiency to enhance private sector job opportunities, and lowering overall corporatization adjustment costs by increasing the private sector demand for labor.

D. Financial Sector Reform and Sequencing

PE reform and financial reform are both long-run co-dependent reforms, they need to be coordinated. For example, large-scale PE privatization should be preceded by, accompanied by, and followed by financial sector reforms. Specifically, to initiate financial sector reforms and to begin laying the foundation for future reforms, policymakers should begin liberalizing interest rate and directed credit controls, improving the supervisory, regulatory, and legal systems prior to PE privatization. During PE privatization, authorities should continue liberalizing and building a market-oriented financial infrastructure and policymakers should remove impediments to private financial intermediary development and initiate the process of privatizing some state-banks along with or soon after PE privatization.[3] Reforming the financial system is a complex process, however, involving the establishment and staffing of a sound supervisory and regulatory system, developing the legal infrastructure to support a more market-oriented financial system, training personnel in financial and accounting skills, and changing the incentives facing financial intermediaries from trying to satisfy political objectives to trying to provide sound financial services. Banks may need to be privatized, corporatized, or restructured to improve incentives. Thus, unless countries are willing to reform their financial systems comprehensively, aggressive PE reform will have a much smaller chance of succeeding.

[3] PE reform also enhances financial reform. Meaningful financial reform would be difficult if the government uses the financial system to fund a huge PE sector.

III. Brief Review of Public Enterprise Reforms: Evidence from Nine Country Cases

We examine the public enterprise reform experiences of nine countries: Korea, Mexico, Chile, the Philippines, India, Turkey, Egypt, Senegal, and Ghana.[4] Galal (1993) reviews these cases in detail and finds that Korea, Mexico, and Chile successfully reformed, the Philippines enjoyed some success, while the other countries have so far been relatively unsuccessful. This section and Table 3 briefly summarize PE reforms in each country.

A. Korea

Starting in 1980, Korea had three main PE sector reform periods. Early privatization efforts accelerated between 1981 and 1983 when four state-owned banks and two PEs were sold through public offerings. The government's main reform effort took place in the second period and focused on corporatization rather than privatization. Corporatization involved tighter control of PEs by the government through strict budget constraints, explicit limits on access to bank credit, and a rigorous managerial performance evaluation system. From 1983 to 1986, the financial performance of PEs improved substantially and real profits net of government transfers increased by 10 percent, though profitability deteriorated in later years. A more recent privatization drive began in 1987 when the government announced that it would privatize 11 PEs. Although it is difficult to assess the success of the latest round of privatizations in Korea, analysts consider Korea's PE reform program to be successful, especially in demonstrating the short-term effectiveness of corporatization.[5]

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[4] These countries were selected so that they exhibit high variance in their PE reform strategies.

[5] See Economic Planning Board (1991) and Shirley (1989).

B. Mexico

Mexico had two major PE reform periods. From 1983 to 1987, reform focused on privatizing or liquidating small enterprises. Of the 743 firms divested during this period, 154 were sold to private sector, while 589 were liquidated or otherwise disincorporated. The government also initiated some limited corporatization efforts during the first reform period. However, the major reform effort came in the second period, from 1989 to 1993, when authorities privatized larger PEs. Also during this period, reforms were undertaken to improve the efficiency of those PEs which remained under state ownership. The government tried to increase the autonomy and accountability of management of PEs via corporatization. Government supervision of the PEs shifted from a system of ex-ante controls on operations to ex-post evaluation of performance and results. Although it is still early, Mexico's reform program has improved the budget and increased efficiency.

C. Chile

Chile pursued an aggressive policy of PE reform during the last 20 years. The public sector's role in the economy was vastly expanded under the Allende government between 1970 and 1973. During the first reform period of 1974 to 1982, the government privatized many PEs, though some larger PEs remained under state control. The government also implemented serious steps to improve the performance of large PEs through corporatization. They imposed a hard budget constraint on PEs, encouraged a reduction in employment, and tremendously increased the efficiency of the enterprises.

The second reform period began in 1985 and focused on privatization. The government privatized many of the larger, unsold PEs. This second period of privatizations led to a significant reduction in the role of the public sector in the economy. In 1989, PE value added accounted for 14 percent of GDP, compared to 39 percent in 1973. The overall reform experience of Chile was successful in general, especially in corporatization in the first reform period and privatization in the second period.

D. The Philippines

The Philippines never had a very large PE sector. The PE sector grew in the 1970s as a result of "statism" policy and the acquisition of failing enterprises in the 1980s. The government privatized many PEs since 1986, and in general, analysts consider Philippine privatization to have been relatively successful.[6]

E. Egypt

In Egypt plans to reform PEs date back to the late 1970s, without much real action until very recently. Most reform efforts focused on corporatization and have been relatively unsuccessful. Recent corporatization efforts intend to give managers of PEs similar incentives as private managers. The government indicated plans to insulate PEs from political interference and impose hard budget constraints. Recently the government has been increasingly emphasizing PE privatization. The privatization program announced in May 1990 contemplates divestiture of 240 PEs, but there has been little progress.

F. Turkey

Turkey initiated the process of PE reform in 1980 in response to increasing budgetary pressures. Until recently, reform focused mainly on corporatization. Despite initial gains, PE performance has not improved much. By 1991, the PE sector was unable

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[6] See World Bank (1993) "Project Completion Report: Philippines - Reform Program for Government Corporations (Loan 2956-PH)," Report no. 11768, and Galal (1993).

to cover interest payments through its operating surplus. More recently, the new government is re-vitalizing reform plans for privatization.

G. India

India's PEs occupy a central position in the economy. Although the need to reform PEs has been recognized since the early 1980s, not much real action has been taken till very recently. In 1991 India reduced the number of sectors reserved to the state and announced plans to concentrate future PE development in "strategic" high-technology or essential infrastructure activities. The reform strategy included restructuring or closing all loss-making PEs, gradual disinvestment of the government's shares of selected PEs, and eliminating their special privileges, such as purchase preferences. This was accompanied by a liberalization of trade and investment regulations to facilitate private-sector expansion. Although some progress has been made, India's PE reform effort has not been successful so far.

H. Senegal

Senegal started its PE reform in 1978 and initially focused on corporatization. The authorities implemented performance contracts for 9 PEs, but financial performance did not improve much. Since 1986, the government has been making efforts to liquidate or privatize PEs. Until now, the privatized enterprises were very small with minority government shares. Therefore privatizations did not lead to managerial changes. However, in 1989, the government restructured and decreased its ownership of individual banks to less than 25 percent, which reportedly hardened the financial constraints facing the PEs.

I. Ghana

While Ghana recognized the need to implement PE reform in 1983, it was not until 1987 that a comprehensive reform program was adopted. The government's reform focused on corporatization of strategic enterprises and divestiture of non-strategic enterprises through privatization or liquidation. The success of the PE reform has been quite limited. Corporatization largely failed because sectoral ministries have proven unwilling to refrain from interfering in managerial decisions. Attempts to improve the financial discipline of the PEs have not been successful. The privatization program, which is still ongoing, has had a negligible impact, liquidating or privatizing mostly very small enterprises.

IV. Initial State of the Financial Sector and Public Enterprise Reform

One of the conclusions of this paper is that countries with initially relatively well-developed financial systems enjoy comparatively more successful PE reforms than countries with comparatively underdeveloped financial systems. This section's first two sub-sections develop measures of financial development and establish the linkage between aggregate measures of the initial level of financial development and successful PE reform. The last two sub-sections discuss the role of (1) developed capital markets in expanding the set of privatization options, and (2) developed financial system in promoting different types of corporatization.

A. Measuring Financial Development

We first identify the indicators that we use to evaluate the extent of financial development of nine country cases. Each indicator is imperfect and suffers from a number of conceptual problems, but together they provide a useful "picture" of financial development. We then discuss how the financial indicators compare across regions of the world with different per capital income levels. Finally, based on these financial indicators we classify the case-study countries into three categories of financial development prior to starting their respective PE reforms.

A.1. Financial Indicators: We mainly use four indicators to assess the state of financial sector development. The first is a traditional measure of "financial depth:" the size of the formal financial intermediary sector relative to economic activity. We call this indicator DEPTH, defined as the ratio of liquid liabilities of the financial system to GDP.[7] This is an indicator of the degree to which the formal financial sector mobilizes domestic savings, so that larger depth should in most cases reflect greater financial development.

However, the size of the financial system may not capture financial services such as risk management, information processing, and corporate governance. The extent of development of a country's stock market may augment the information contained in DEPTH by capturing these financial services, since better developed stock markets make it easier for individuals to price and diversify risks, to raise capital, and to take-over poorly managed firms. Thus, the second indicator we use is a traditional measure of stock market development, MCAP/GDP, the ratio of market capitalization to GDP.[8] Higher values of MCAP/GDP should reflect greater financial development.

Our third indicator measures the importance of private non-bank financial institutions by computing the share of private non-bank financial intermediary assets in total financial assets. Non-banks complement commercial banks, and more importantly, they often function as effective substitutes for the commercial banking sector when that sector is suppressed by government regulations or taxation. Non-banks are less likely to funnel credit to the government or PEs. Thus, for many countries, larger non-bank financial intermediaries reflect a broadening and deepening of the financial system.

Another indicator of the extent of government control in the banking sector is the ownership structure of banks. To the extent there is a large PE sector, banking system is

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[7] Liquid liabilities consist of currency held outside the banking system plus demand and interest bearing liabilities of banks and nonbank financial intermediaries. This equals "M3." When it is not available "M2" is used.

[8] Demirgüç-Kunt and Levine (1993) discuss a broad range of stock market indicators.

generally dominated by public banks that provide financing to the PEs at non-market terms. If the banking sector is mostly private however, PEs are less likely to have access to subsidized financing. Thus, our fourth indicator is commercial bank ownership which captures the banking sector's degree of independence from the government and the extent of competition in the credit market.

A.2. Comparison Across Different Regions: Figure 1 gives the 1991 averages of three of our financial indicators for four regions of the world: Sub Saharan Africa (Africa), Latin America (LAAM), Asia, and the OECD. 1991 GDP per capita figures for Africa, Latin America, Asia, and OECD are $705, $1489, $2611, and $15,016, respectively. As shown in Figure 1, moving from poorer to richer countries generally involves greater financial development as defined by our financial indicators. Although none of the indicators is perfect, overall they illustrate a useful pattern. OECD countries lead with the highest level of financial development since all our indicators, non-banks, MCAP/GDP, and DEPTH have the highest values for OECD. Asian countries follow with high financial depth and stock market capitalization. The importance of non-bank financial institutions is a distinguishing factor, since for Asian countries our indicator is quite lower than that of OECD countries. Latin America follows Asia with considerably lower financial depth and stock market capitalization. African countries have the lowest level of financial development, with lowest non-bank and MCAP/GDP values, although the value for DEPTH is slightly higher than that of Latin American countries. Based on Figure 1, these indicators in general, provide an intuitively appealing ranking of financial development across countries. Now, we turn to evaluating the initial level of financial development in our case countries prior to their PE reforms.

A.3. Classifying the Case-Study Countries based on the Initial State of their Financial Sectors: When the financial systems of countries prior to PE reforms are ranked based on the four indicators, DEPTH, MCAP/GDP, the importance of private non-bank financial institutions, and bank independence from government, they fall into three categories along a spectrum (see Table 4). Korea, Mexico, Chile II, and the Philippines had relatively well-developed financial systems prior to undertaking PE reforms. Financial depth was over 30 percent of GDP, and they had relatively significant stock markets. Their private non-bank financial intermediaries had a significant share of financial assets (around 15 to 30 percent) complementing the commercial banks. Senegal and Ghana, are at the other end of the spectrum with underdeveloped financial systems. They had low levels of financial depth, no stock markets or private non-bank financial institutions in the formal sector, weak banking systems, and generally a very underdeveloped financial infrastructure. Finally, Chile I, Egypt, Turkey and India[9] are difficult to rank and fall in between, since their financial systems are not as underdeveloped, but still less-developed compared to the first group of countries.

B. Initial Financial Development and Public Enterprise Reform

The experiences of the nine countries we study indicate a strong correlation between the initial state of their financial systems and the success of their PE reforms. As Table 4

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[9] India has large and diversified financial intermediaries and its capital market is one of the oldest and largest among developing countries. However, the Indian financial system is publicly-owned for the most part and very highly regulated. Since the indicators we use attach great importance to existence of private institutions and independence from government interference, India is not ranked within the first group of countries.

shows all of the most successful PE reform cases started out with relatively well-developed financial systems. Korea, Mexico, Chile-II, and the Philippines had higher levels of financial depth, relatively well-developed stock markets, and other non-bank financial institutions prior to undertaking their PE reforms than the other cases.

Countries that started out with less developed financial systems (Chile-I, India, Turkey, Egypt) or under-developed financial systems (Senegal and Ghana) were not as successful in their PE reforms. These countries had lower financial depth, highly regulated banks, less developed non-banks, and either insignificant or nonexistent stock markets prior to their PE reforms. One apparent exception is Chile's successful corporatization in its first reform period. However, Chile's corporatization involved greater government control of enterprise managers, investment and financing decisions, and therefore relied much less on the initial state of its financial sector to provide these services to PEs.

The nine country cases are consistent with the hypothesis that an initially well-developed financial system promotes successful PE reforms. As discussed in conceptual overview, a well-developed financial system will tend to assist PE reform by allocating funds to more efficient firms, by forcing other firms to restructure or fail, and by efficiently redeploying the assets of these bankrupt enterprises. While an initially well-developed financial system facilitates PE reform, countries with initially less-developed financial systems should not give up undertaking PE reforms. As we discuss below, financial reform is a long-term process that can be synchronized with PE reforms to promote success.

C. Initial Stock Market Development and Public Enterprise Reform

In our country cases, the initial state of the stock market seems to have played a role in influencing the PE reform strategy and the eventual success or failure of the reform process in at least two ways. First, the existence of a well-developed stock market provides different alternatives for privatization; and second, a well-functioning stock market can be an important source of financing for privatization transactions.

C.1. Privatization Strategy: The extent of stock market development helps determine available options for privatization. Privatizations are usually handled through: (i) public offerings, in which the shares of the PEs are sold on the stock exchange resulting in a widespread public ownership, or (ii) block sales of the enterprise to a single purchaser or group of investors, resulting in more concentrated ownership.

A well-developed stock market promotes privatizations by enabling public offerings. Using a public offering to obtain widespread public ownership of enterprises requires a sufficiently liquid stock market to be able to absorb the new issues without negatively affecting the market as a whole. In Chile's first reform period, when the stock market was not adequately developed, the government sold controlling stakes of the enterprises in auctions. This concentrated economic power in the hands of a few groups. In the second reform period, however, Chile's stock market was much more developed as a result of the earlier financial liberalization, the simultaneous strengthening of the regulatory and supervisory framework, and the privatization of the pension fund system. Thus the government was able to sell small to medium-sized packages of shares through the stock market and obtain a broader distribution of ownership.

The existence of a well-developed stock market also makes it easier for governments to privatize since privatizations that lead to widespread public ownership are often politically more acceptable to the public than sales to a small group of investors - particularly if the investors are foreign. Also, public share offerings have a great advantage over private sales in terms of transparency, particularly in countries where less than completely clean transactions between private and public sectors have been common. For example, in Turkey block sales of PEs to foreign investors were extremely controversial and led to charges that the government was essentially giving away public assets to foreigners. When the government decided to privatize by public sales through the stock exchange, this change was welcomed by the public.[10] Another example is Mexico, where block-sales of the PEs have also been criticized for favoring a few investors, who have become very rich as a result of the privatizations.[11]

Well-developed, booming stock markets can also help decrease opposition to privatization by making employee or management buyouts feasible. A good example is the privatization of TELMEX, the Mexican phone company, in which the union was offered 4.4 percent share of the company for $325 million. Following its privatization, the market value of TELMEX rose to $30 billion, resulting in an increase of 400 percent over the employees' purchase price.[12] Such gains make it very difficult for unions to oppose privatization, even if it is likely to result in job losses. Chile also relied on share purchases by employees to some extent in its second period of privatizations, when the Chilean stock market was booming.

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10 Although complaints arose as soon as the prices of shares started to fall. See Saeger (1993).

11 See The New York Times, October 27, 1993.

12 See Pankaj Tandon, "Mexico," from *Welfare Consequences of Selling Public Enterprises: Case Studies from Chile, Malaysia, Mexico and the UK*, The World Bank, 1992.

Conversely, underdeveloped stock markets may hamper the ability of the government to structure a privatization satisfactorily. For example, Swanson and Wolde-Samait (1989) assert that one of the reasons for failure of the Ghanaian and the Senegalese privatization efforts was the lack of a domestic equity market on which public share offerings could be floated. Early privatization efforts in Turkey were also adversely affected by the relatively under-developed state of its equity market. A government announcement in 1987 that it planned to accelerate its privatization program through new issues was one of the important factors that caused a sharp fall in the market and stalled the reform program. Even when there is a well-developed stock market, success of privatization strategies which rely heavily on public offerings depend to a large extent on the general stock market environment. For example, Korea also used its stock market in its privatization program, however slowed down its efforts partly due to a down turn in its stock market since 1989.[13]

C.2. Financing of Privatization: Both public offerings and block sales must draw on domestic or foreign savings. Stock markets can play an important role in financing the privatizations by complementing the banking system's ability to mobilize savings. For example in Ghana, a number of agreed privatization transactions could not be completed due to the inability of the purchasers to secure financing.[14] The Mexican privatization program used a sealed-bid auction process to sell controlling stakes in each company and therefore, the stock market was not the direct mechanism of sale. However, the stock

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[13] See Saeger (1993).

[14] See World Bank, "Regional Study on Public Enterprise Reform and Privatization in Africa," 1993.

market still provided important support as groups involved in the bidding issued equity to finance their bids. Eight financial groups raised a total of over 4 billion pesos in new equity in 1992, including 2.4 billion pesos domestically, to help finance the purchases of the commercial banks. The ability to attract sizable inflows of foreign portfolio investment also enhances the viability of a privatization program. Indeed, privatization programs in both Mexico and second period of Chile benefitted greatly from an inflow of foreign portfolio investment to their stock markets.

C.3. Privatization and Stock Market Development: Although the existence of a well-developed stock market is important in structuring a successful privatization, the absence of a highly-developed stock market should not be used as an excuse not to privatize. If carefully implemented, privatization itself can make a major contribution to capital market development. It is true that the absence of a domestic equity market makes a conventional public offering of shares through brokers infeasible. But governments committed to reform have found alternative ways to sell PEs to domestic wealthholders. For example, Turkey used bank branches as a substitute for brokerages in the 1988 divestiture of the government's minority stake in Teletas, and in the privatization of the Bosphorus Bridge and the Keban Dam, which were heavily oversubscribed and sold to a total of 15,000 domestic investors. These banks are now building upon the experience with those sales and attempting to capitalize on the rapid development of capital markets by evolving into universal banks. The Chilean privatizations since 1985 have involved the sale of stock to institutional investors and employees equal in value to nearly 10 percent of the domestic stock market capitalization. Again, rather than putting stress on the stock market, the increased capitalization has strengthened it. In Senegal, the government was even able to sell a small share offering by newspaper.[15]

Admittedly, privatization in the absence of a well-developed stock market does require flexibility in structuring the privatization, including greater reliance on private share placements than might be necessary with a developed stock market. It also requires creativity in marketing and distributing shares to the market. In addition, the cost of rejecting foreign participation in the privatization program will be higher when domestic capital markets are weak. Nevertheless, a well-developed stock market is not a necessary condition for privatization.

D. Initial Financial Development and Corporatization

An initially well-developed financial system promotes corporatization that relies on greater PE autonomy as well corporatization that involves enhanced government oversight. Corporatization that relies on greater public enterprise autonomy requires a sufficiently well-developed and independent financial system to impose hard budget constraints and cultivate market-based incentives, while a well-developed financial system indirectly supports corporatization involving tighter government monitoring by promoting private sector development. Successful corporatization in Korea and Chile-I involved intensified government monitoring of managers and strict enforcement of budget constraints. The government did not abdicate these responsibilities to the financial system. Nonetheless, successful financial reform in Korea helped corporatization indirectly. By enhancing resource mobilization, credit allocation, and corporate governance of private firms, financial

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15 See Gavin (1993) for all these examples.

reforms in Korea contributed to private sector development and thereby indirectly improved "corporatized" PEs. Specifically, private sector growth seems to have promoted successful corporatization by intensifying competitive pressures on PEs and increasing labor demand, which eased political pressures on large PEs that are reducing labor to improve financial performance.

In contrast, PE reform efforts in Senegal and Ghana were less successful than they otherwise might have been because their corporatization efforts included greater PE autonomy from the government without a sufficiently well-developed financial system to impose a budget constraint and monitor managers. Thus, banks continued to finance PE losses, perhaps because of implicit government guarantees, and did not provide sufficient incentives for PE managers to improve enterprise efficiency. Thus, corporatization that relies on greater PE autonomy requires a sufficiently developed and independent financial system to impose budget constraints and cultivate market-based incentives, while a well-functioning financial system will indirectly bolster corporatization involving intensified government oversight by promoting private sector development.

V. Financial Reform and Public Enterprise Reform

This section discusses the linkages between PE reform and financial sector reform.

A. Countries that successfully implemented large-scale PE reforms also implemented successful, large-scale financial sector reforms. The financial reforms first involved interest rate liberalization, reduced directed credit, and less direct government control of financial intermediaries. In successful countries, these first set of financial reforms were followed by (1) enhanced supervisory and regulatory capabilities and (2) a shrinkage of public banks and an expansion of private financial intermediaries through bank privatization and strengthening of private financial intermediaries. As discussed above, there were three cases of successful large-scale PE reform: Mexico-II, Chile-II, and Korea; each of these countries also executed successful financial reforms.

First, consider Mexico-II where between 1989 and 1993 the authorities privatized many large PEs. In 1982 there were 60 private financial institutions, including 35 banks. In response to the economic crisis, the government nationalized all but two of these banks in 1982 and reduced the number of state-owned banks to 18 through mergers and closures. From 1982 to 1988, the government tightly controlled the banking system and used commercial banks to finance the government and PEs. Banks faced high reserve ratios, interest controls, and had to lend most of their funds to PEs and favored sectors at concessionary interest rates. Operating in a uncompetitive environment, over-manning and inefficiencies blossomed in state-banks. During this period, non-bank financial sector - primarily brokerages, which were often managed by previous managers of the commercial banks - operated in a much less repressed environment and became important sources of finance for the private sector. By 1987, nonbanks held more than 50 percent of financial system's assets, and state-banks held less than half (Euromoney, Jan. 1993).

Financial liberalization began late in 1988. The government freed interest rates, eliminated forced investment in government securities, and abolished exchange controls, while also strengthening the regulatory environment by imposing capital limits and conservative prudential regulations. The stock market, which had deteriorated in the 1980s, started improving with the liberalization. Bank lending to the private sector increased from 25 percent of total assets in 1986 to almost 60 percent in 1991.

Liberalization and improvements in the regulatory system set the stage for privatization of the entire commercial banking system in 1991-1992. Accompanying privatization, the government intensified programs to improve supervision and regulation. Although it is too early to judge the success of Mexican financial reform, many observers consider Mexican bank privatization a success and a model for other countries.

The private banking system is helping to finance industrial growth, including the re-tooling and re-orientation of former PEs. Mexico's financial system is relatively well-developed, with an active securities market (market capitalization is around 36 percent of GDP), a diverse set of non-bank financial intermediaries, and a thriving commercial banking industry such that financial DEPTH is greater than 33 percent. Financial reform accompanied and seems to have assisted PE privatization. The case of Mexico-II is consistent with the view that large-scale PE privatization will typically require meaningful and effective financial sector reforms - including bank privatization - to bolster the provision of critical financial services to the growing private sector.

The results from Chile-II also support this conclusion. Chile began its second PE reform episode in 1985. The authorities re-privatized companies that were taken-over by the government during the 1982 economic crisis and also sold large PEs that had not been privatized during Chile's first PE reform episode in 1974-1982. During Chile-II, the authorities also implemented important financial sector reforms and designed many of these reforms to avoid the circumstances that contributed to the 1982 crisis.

During the first reform period, the government implemented many financial reforms. They abolished interest rate ceilings, eliminated credit allocation controls, reduced banks' reserve requirements, freed capital controls, and allowed new entry. The authorities also privatized state-banks during Chile-I but without first establishing a sound regulatory and supervisory system. New bank owners used their privileged access to credit to purchase PEs, thus establishing a small number of huge conglomerates. In the absence of effective regulation, this provided an environment amenable for unsound banking practices and contributed to the economic crisis of 1982 that will be discussed below.

Following the 1982 crisis, Chile recapitalized and re-privatized the banks. Importantly, during this second reform episode, Chile significantly strengthened the role, staff, and funding of prudential supervision and regulation. In addition to its banking system, Chile also has non-bank financial intermediaries, including a large private pension funds. Today, Chile's private financial system is quite well-developed and supports a booming private industrial sector. Financial DEPTH is almost 50 percent of GDP, and the stock market capitalization to GDP ratio is over 95 percent. Thus, Chile-II is also consistent with the hypothesis enunciated above: large-scale public enterprise reform benefits from financial sector reforms which include liberalization, strengthening of prudential supervision and regulation, and privatization.

Korea also combined large and generally effective PE reform with significant financial sector reforms during the 1980s, though Korea's PE reforms focussed primarily on corporatization. Korea's corporatization efforts involved intensified government monitoring of pubic enterprises through a rigorous managerial performance evaluation system.[16] These reforms improved PE performance.

Korea also initiated important financial sector reforms during the 1980s. Early in the reform process Korea liberalized interest rates, reduced directed credits, lowered entry barriers, and formalized the curb market into an important and booming private nonbank financial intermediary sector. Korea strengthened supervisory procedures of both banks and nonbanks during the 1980s. Banks were also privatized in 1983, but without cleaning their portfolios of bad loans or recapitalizing the banks, so that the privatized banks remained dependent on the government for subsidies. Later bailouts of both nonfinancial firms and banks decreased the non-performing loans to less than 1 percent of commercial banks assets, but the government still retains significant control over bank lending decisions. While bank lending as a share of GDP stagnated in the 1980s, nonbank credit as a share of GDP has boomed from around 10 percent in 1976 to close to 40 percent by the end of the 1980s. Thus, as in Mexico-II and Chile-II, financial liberalization, a strengthening of supervision and regulation of financial intermediaries, and development of financial intermediaries focussed on providing market-oriented services also accompanied successful

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[16] Korean corporatization also involved greater autonomy of day-to-day management decisions while keeping management criteria focused on bottom line issues.

PE reform in Korea. Although the independent relationship between financial reform and corporatization is difficult to assess, it is important to establish that successful large-scale corporatization went hand-in-hand with substantial financial sector reforms.

B. Countries that were less successful in reforming PEs did not implement successful financial sector reforms (including liberalization of interest rates and credit decisions, enhanced supervision and regulation, improvements in legal codes and enforcement capabilities, and public bank privatization) along with or before PE reform. As noted above, Egypt, India, Turkey, Ghana, and Senegal have had, on aggregate, much less successful PE reform than Korea, Mexico-II, Chile-II, and the Philippines. Importantly, these same countries also did not implement comprehensive financial reform and bank privatization - on the scale attained by Mexico-II, Chile-II, and Korea - early in their PE reforms. Recent Turkish financial reforms, however, should facilitate future PE reforms.

The remainder of this section reviews financial reform efforts in Egypt, India, Turkey, Senegal, and Ghana. The Appendix provides more details. Reviewing financial reform helps one understand why PE reform has been relatively less successful in these countries and what financial reforms need to be stressed in the future.

B.1. Egypt and India: During the 1960s and 1970s, both Egypt and India pursued public sector led development strategies. Consequently, state-owned banks dominate the financial landscape in both countries. For example, state-owned banks hold over 90 percent of total banking asses in India and and over 50% in Egypt. State banks are used to finance government expenditures and provide subsidized credits to PEs. Furthermore, both countries used pension reserves to finance PEs, public banks, and government projects.

Prior to the 1980s, there were heavy taxes on banks, stiff barriers to entry, tightly controlled interest rates, and inadequate prudential supervision and regulation. In both Egypt and India, financial reforms started in 1992. Egypt and, to a lesser degree, India have eased interest rate controls, strengthened prudential regulation and supervision, relaxed entry barriers, and capitalized some weak public banks. Reform efforts are continuing in both countries with the goals of reducing domination by state banks and increasing private sector participation. Serious bank privatization has not yet occurred in either country; though, Egypt privatized one public-private joint-venture in 1993. While Egypt and to a somewhat lesser degree India are setting the stage for successful PE reform in the future by reforming the financial system, successful large-scale PE reform will probably require a greater willingness to privatize large state-banks if they are to break the legacy of state-dominated finance.

B.2. Turkey: Turkey initiated PE and financial sector reform in the 1980 as PEs increasingly used government transfers, loans from state banks, pension reserves, and credits from the Central Bank to cover operating expenses. The main focus of the reform program was on deregulation to increase competition and efficiency within the financial system. The government removed interest rate ceilings on interest rates, relaxed restrictions on domestic and foreign bank entry, and expanded the scope of banking activities. Another element of the government's stabilization program was tight monetary policy which led to high interest rates. While the liberalization of interest rates was successful in greatly increasing the mobilization of savings through banks, high interest rates caused difficulties for corporate borrowers. Firms increasingly borrowed to cover interest payments, and banks started to compete fiercely to attract new deposits. Given inadequate regulation and supervision, the eventual result was a crisis in 1982, which led to the closure of several private banks; liberalization without adequate supervision helped foster financial instability.

The crisis shifted the emphasis of the reform program from deregulation to building a sound regulatory framework. The government reimposed ceilings on deposit rates, enacted the banking law of 1985 which initiated the process of improving prudential regulations, and established the Capital Market Board to regulate and develop securities markets. Interest rates were again liberalized in 1988, although some ceilings still remain.

Turkey's financial system has developed significantly in the last decade. Financial DEPTH is around 32 percent, stock market capitalization is almost 20 percent of GDP, and nonbanks are growing. However, financial intermediation is still heavily taxed both directly and indirectly through high reserve and liquidity ratios, and state-banks have not been privatized. The banking system remains 50 percent publicly-owned. Recently, the government slated several state banks for privatization.

B.3. Ghana: In Ghana, PEs play a dominant role in most sectors of the economy, and state-owned banks dominate the financial system. PEs are very heavy users of bank credit often with government guarantees, and taxes, tariffs, and social security funds all support PEs. Indeed the financial system is best viewed as an extension of the fiscal system which is used to finance priority PEs. There is little to no systematic monitoring of credit to public enterprises and non-payment by PEs is a huge problem.

Some financial sector have been implemented in Ghana. In 1987-88, interest rates controls and sectoral credit targets controls (except .ɔ agriculture) were eased, and the Bank of Ghana began using indirect monetary control instruments. In 1989-1992, Ghana established the Non-Performing Assets Recovery Trust to recapitalize seven banks, and efforts were initiated to strengthen accounting, provisioning for bad loans, supervision, and legal reforms. Furthermore, Ghana plans to reduce financial intermediary taxes, encourage positive real interest rates, and divest some public sector banks in the future. At present, however, the financial system is still very underdeveloped with a DEPTH of 19 percent and stock market capitalization of around one percent of GDP. Significant financial sector reforms will have to continue and probably intensify for PE reform to promote economic development successfully in Ghana.

B.4. Senegal: Senegal's PE sector accounted for almost 30% of total investment, about 17% of total employment, and 7% of GDP in 1988. In addition, the government plays a very heavy role in regulating private sector activities and allocating resources. In 1989 Senegal initiated a banking reform. This included a bank restructuring and closure of some distressed banks, privatization of some of the restructured banks, a reduction in directed credits, and elimination of government guarantees of PE borrowing, and a reduction of government ownership of all banks to less than 25 percent. Although Senegal still has a very underdeveloped financial system with a financial DEPTH of 25 percent and no stock market, the financial sector reforms are promising steps. As these financial reforms improve financial development and if Senegal strengthens existing efforts, the ability of the Senegalese financial to provide market-oriented financial will grow and foster more aggressive PE reform.

C. Countries that implemented modest - though successful - public enterprise privatization in the presence of an already relatively well-developed financial system did not simultaneously implement large financial sector reforms. The Philippines successfully privatized a limited number of government corporations in the late 1980s. As indicated in Table 4, the Philippines already had a relatively deep financial system with a well functioning capital market, a strong nonbank sector, and private commercial banks when it initiated PE reform. Financial reform in the first half of the 1980s helped build a financial system capable of supporting enterprise reform in the second half of the 1980s. Specifically, liberalization of interest rates in the early 1980s, strengthening of the legal framework, bankruptcy laws, regulations, and prudential enforcement capabilities in 1987, and reduction in the role of public banks from 28% of banking assets to 14% of banking assets over the 1980s helped mold a financial system that was ready to support modest public enterprise privatization in the late 1980s.

Similarly, Mexico's first PE reform from 1981-1987 was not accompanied by substantial financial sector reforms. This first reform period focused on privatizing and liquidating small enterprises and limiting the losses of large PEs. Although Mexico's banking system was publicly owned during this first reform period, Mexico had a relatively well-functioning capital market and very well-developed nonbanks. The experiences of the Philippines and Mexico-I are consistent with the view that if the financial system is sufficiently well-developed at the start of the PE reform process and PE reform is of a modest scale, then substantial financial sector reforms do not have to be implemented to promote successful PE reform.

D. Unsuccessful financial sector reform can hurt large-scale public enterprise reform. Chile implemented large-scale PE and financial reforms during their first reform episode, 1974-1982. Out of the 504 firms controlled by the government in 1973, only 109 remained publicly owned in 1982. In all sectors except mining, government's share of production fell by about 70 percent. The government also imposed a rigid budget constraint on PEs: PEs had to self-finance projects; any borrowing from banks had to be cleared with officials under strict guidelines; and no government guarantees were issued. Thus, the private sector grew substantially, and corporatization improved PE performance.

Chile's financial liberalization and bank privatization, however, facilitated the 1982 crisis.[17] Specifically, banks were privatized before nonfinancial PEs. Business conglomerates - grupos - purchased most of the banks with only a 20 percent down payment and borrowed the remainder from the government. Grupos then used loans from their banks to purchase nonfinancial firms, where the government required only a down payment of between 10 and 40 percent. This highly-leveraged concentration of industrial and financial power together with an ineffective, understaffed, and under-funded bank supervisory system encouraged insider lending, reduced the effectiveness with which banks evaluated clients, and weakened objective bank monitoring of firm managers. When domestic economic problems, external shocks, and inconsistent foreign exchange rate policies, caused some nonfinancial grupo firms to flounder, the grupos used their banks -

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17 See Cortes-Douglas (1992), De la Cuadra and Valdes-Prieto (1992), and Edwards and Edwards (1987).

with government insured deposits - to support failing firms in a doomed attempt to avoid realizing losses. In the resulting 1982 depression, GDP fell by 14 percent, unemployment soared past 25 percent, and the government had to take control of enterprises and banks that accounted for 60 percent of total bank deposits. While changes in world interest rates and inconsistent exchange rate and wage policies would have combined to negatively affect the Chilean economy with or without the financial reforms on the late 1970s, the lack of sound prudential supervisory and regulatory capacity created a fragile financial system that exacerbated the economic down turn and mitigated the success of Chile's first PE reform episode. Chile's experience suggests bank privatization and liberalization of interest rates and credit controls are not enough. Sound supervision and regulation must also be in place or the financial system will not be able to support aggressive PE privatization.

VI. Conclusions and Policy Recommendations

We find a striking link between financial development and the success of public enterprise reform: countries with initially relatively well-developed financial systems enjoyed better PE reform than countries with less well-developed financial systems; and, countries that synchronized financial reform with PE reform enjoyed greater success than countries that tried large-scale PE reforms without improving their financial systems. Since we only examine nine cases and focus only on the financial system among many other factors - macroeconomic, political, institutional, labor market, and product market factors - that may affect the success of PE reforms, our conclusions are suggestive. Nevertheless, by highlighting the linkages between the financial system and PE reform we seek to emphasize that once all the other conditions for a successful PE reform are met, those reforms that also incorporate financial factors will have a greater probability of success.

Based on our analysis, we make the following tentative recommendations for countries contemplating public enterprise reform:

(1) If a country has an initially very under-developed financial system, PE reformers should consider a strategy that relies less on the financial system for its initial success and start developing the foundations for a well-functioning financial system. Specifically, corporatization that consists of improved direct government monitoring of enterprise managers, firm investment decisions, and PE financing may contain losses and improve performance without relying excessively on the financial system. At the same time, financial reforms, especially liberalization and improvements in

legal, supervisory, and regulatory systems, should be initiated to establish the financial sector basis for more comprehensive, large-scale PE reform involving expanded enterprise autonomy and privatization and also for more comprehensive and complementary financial reforms involving state bank privatization and further liberalization and financial infrastructure building.

(2) If a country has an initially relatively well-developed financial system, and the country decides to implement large-scale PE reform, the reform should be synchronized with substantial and well-designed financial sector reforms. Large scale PE reform involves much greater reliance on the services provided by the financial system. Therefore, a comprehensive PE reform should also involve the reform of public banks that often exist to serve the PE sector. A sound financial reform which includes bank privatization is an important component of any large-scale PE reform and its design is crucial since just as well-designed financial sector reforms can promote PE reform, poorly designed financial sector reforms can jeopardize the success of the PE reform.

(3) If a country has an initially relatively well-developed financial system, and the country decides to implement small to moderate-scale PE reform, then the reforms can succeed without substantial financial sector reforms. However, unless the PE sector is small to start with, small-scale PE reforms, by definition, will still leave much work for future reform efforts.

(4) If a country has an initially relatively well-developed financial system, the country can also choose between different types of reform in addition to choosing the scale of the PE reform. A well-developed financial system will promote all PE reform strategies either directly (privatization, private sector development, corporatization with increased autonomy) or indirectly (corporatization with greater government control). Since these are all feasible choices for a country with an initially well-developed financial system, the choice may be based on other factors such as political pressures or relative sustainability of different options.

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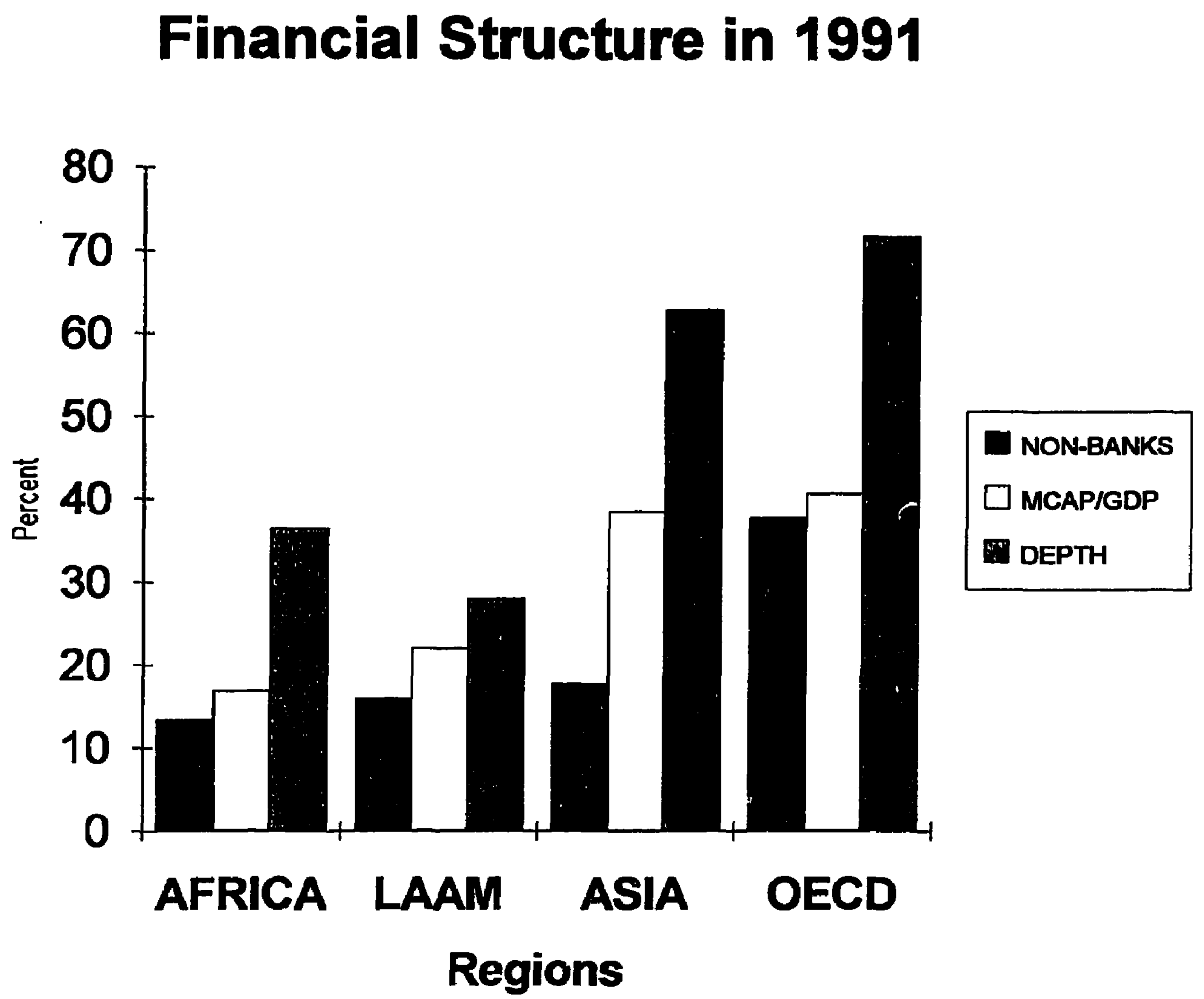
Figure 1



Non-Banks: Non-bank financial intermediary assets as a percent of total financial assets

Depth: M3/GDP

MCAP/GDP: Stock Market Capitalization divided by GDP

Table 1: Privatization and the Changing Provision of Financial Services

	Less reliance on:	More reliance on:
Mobilizing Resources to finance enterprises	- Taxes - State-owned banks	- Financial intermediaries: Banks, investment companies, pension funds, insurance companies - Capital markets
Allocating Resources to enterprises	- Direct and indirect government subsidies and guarantees - State-owned banks - Private banks compelled by the state	- Financial intermediaries: Banks, investment companies, pension funds, insurance companies - Capital markets
Corporate Governance of enterprises	- Government or government ministries	- Financial intermediaries: Banks, investment companies, pension funds, insurance companies - Capital markets

Table 2: Financial Development and the Success of Public Enterprise Reform

	Under-Developed Financial System		Well-Developed Financial System	
Privatization/ Private Sector Development	Execution:	Difficult to privatize with poorly functioning banks and capital markets	Execution:	Easier to privatize with liquid, well-functioning equity markets and sound banks
	Prospects:	Poor: Sustainable private sector growth requires a sound financial system	Prospects:	Good: Financial system will support and promote private sector growth
Corporatization with Greater Autonomy	Prospects:	Poor: PEs will receive poor services; lack of corporate governance could be disastrous	Prospects:	Better: Financial system will service PEs.
		Unsustainable & Not Credible: Financial system will not provide good services; government will eventually mobilize, finance, and govern PEs.		Sustainability?: Performance may improve, but government may renege on autonomy and exert pressure to fund politically popular PEs
Corporatization with Less Autonomy	Prospects:	Fair: Financial system minor factor in outcome	Prospects:	Better: Financial system will promotes private sector and therefore indirectly help corporatization

Table 3. PE and Financial Sector Reforms

Country	PE Reform Period	PE Reform	Financial Reform Period	Financial Reform
Korea	I. 1981-1983	Privatizations. Four state-owned banks and two other PEs were sold through public offerings although government influence remained strong. Program was reportedly successful in increasing efficiency.	1980 -	A gradual reform started in 1980. Deposit rates were partially liberalized to establish positive real rates. Preferential lending rates were abolished in 1982. Privatization of the public city banks started in 1982 and was completed by 1983. Restrictions on non-bank financial institutions were relaxed. New domestic entry into the financial system was allowed. A gradual opening up to international competition started. Capital markets were also gradually opened to foreign participation. Lending rates were officially deregulated in 1988. In 1991, government announced a plan to completely deregulate money market and deposit rates by 1997.
	II.1983-1985	Corporatization. Financial performance of PEs improved substantially, although started deteriorating later. The program was very successful in the short run.		
	III. 1986-	Privatizations. In 1991, 7 PE subsidiaries and Korea Stock Exchange were privatized. Government is planning to privatize 11 more PEs, while remaining a majority shareholder in 6. It is too early to tell if the program is successful.		
Mexico	I. 1983-1987	Privatization/liquidation of small PEs. Corporatization of large PEs. 743 small PEs were liquidated or sold. Corporatization had limited success.	1988-	Financial sector reform started in 1988 with liberalization of interest rates. Exchange controls were abolished, forced investment in government securities was eliminated and most of the restrictions on commercial bank activity were lifted during 1989. Regulation and supervision were strengthened during 1989-1990. Banks privatization started in 1991 and was completed in 1992.
	II.1988-1993	Privatization of large PEs. 192 large PEs were privatized. The privatization program is considered to be very successful, both in terms of budgetary impact and increase in efficiency.		
Chile	I. 1974-1982	Privatization of small PEs and corporatization of remaining ones. Most of the privatized PEs were re-nationalized after the 1982 crisis. Corporatizations were successful in improving the performance of PEs.	1974-	Financial liberalization started in 1974 with interest rate liberalization. Banks were privatized (1975-77). Entry restrictions were relaxed, credit ceilings were eliminated, permitted scope of activities were expanded. Pension funds were privatized in 1980. Restrictions on foreign capital inflows were gradually lifted starting in 1977, and capital account was completely liberalized in 1980. Financial crisis came in 1982 and the government had to clean up and bail out the banks. After the crisis, prudential regulation and supervision was strengthened, culminating in the passage of a new banking law in 1986.
	II.1985-1990	Privatizations. After re-privatization of firms which had reverted to government control during the financial crisis, larger PEs were also privatized. This led to a significant reduction in the role of the public sector in the economy. The privatizations are viewed as being very successful.		

Country	PE Reform Period	PE Reform	Financial Reform Period	Financial Reform
Philippines	1986-	Privatizations. Although privatizations are still continuing, government's privatization efforts are considered to be successful, both in quantity and impact.	1980-	Financial sector reform focused on strengthening the banking system, reducing taxation and increasing competition. Banks were allowed to expand into new areas of activity and loan and deposit rates were freed. The share of public banks in total banking assets was reduced from 28% in 1980 to 14% in 1990. The reform also started to address institutional features such as the legal framework and bankruptcy laws.
Egypt	1980-	Reform efforts mostly focused on corporatization and were unsuccessful. Recently there is revived interest in corporatization and privatization.	1992-	Financial sector reform only started in 1992. Interest rates were liberalized and prudential regulation and supervision were strengthened. Banks were recapitalized and entry barriers were relaxed. In 1993, one private/public joint-venture bank was privatized.
Turkey	1980-	Although there was limited success with corporatization initially, generally neither the corporatization or privatization efforts have been successful. Recently, there are new efforts focusing on privatization.	1980-	Financial sector reform started with interest liberalization on deposit and loan rates in 1980. Commercial banks were deregulated and foreign bank entry was allowed. Financial crisis came in 1982. Interest ceilings were re-imposed and a deposit insurance system was established. Later reforms emphasized prudential regulation and improved supervision leading to a new banking law in 1985. Interest rates were partially liberalized in 1988. Recently several state-owned banks were slated for privatization.
India	1980-	Corporatization efforts have not been successful. There have been new corporatization and privatization efforts since 1991.	1992-	Financial sector reform started quite late, in 1992. Entry and expansion conditions have been made less restrictive. Interest rates on term loans and most debt instruments were recently decontrolled and increased. Reform efforts to improve prudential and regulatory environment, to recapitalize weak institutions, and to promote greater private sector participation and further financial policy liberalization are continuing.
Senegal	1978-	Corporatization and privatization efforts have been unsuccessful so far.	1989-	Financial reform program started in 1989, and included restructuring of public banks, increasing capital requirements, and improving banking supervision. Government ownership in each bank was decreased to less than 25 percent.
Ghana	1987-	Corporatization and privatization efforts have been unsuccessful so far.	1987-	The financial reform initiated in 1987 included a strengthening of the regulatory framework, liberalization of government controls, and bank restructuring. Interest rates were liberalized in 1988. 1989 banking law strengthened bank regulation and supervision. In 1990, banks were restructured and government announced plans to privatize banks in 1993.

Table 4. PE Reform and the Initial State of the Financial Systems

Country	PE Reform Period	DEPTH	MCAP/GDP	Share of Private Non-Bank Financial Institutions	Commercial Bank Ownership before Reform	Bank Privatization
Well-developed financial systems:						
OECD	n.a.	72	41	38	Mostly private	n.a.
Korea	I. 1981-83 II. 1983-85 III. 1986-	39 40 42	10 8 6	30 32 33	Mostly public 70% private 70% private	Banks were privatized 1982-83, in the first reform period.
Mexico	I. 1983-87 II. 1988-93	39 39	6 6	 15	100% public 100% public	Banks were privatized 1991-92, towards the end of the second reform period.
Chile II	II. 1985-90	38	22	23	Mostly private	Banks were privatized 1975-77, during Chile I.
Philippines	1986-	34	4	16	Mostly private	The share of public banks fell from 28% to 14% of assets, 1980-90.
Less-developed financial systems:						
Chile I	I. 1974-82	33	5	Some	100% public	Banks were privatized 1975-77, early in the reform period.
Egypt	1980-	57	-	Some	Over 50% public	Just starting. In 1993 one joint venture bank was privatized.
Turkey	1980-	32	1	Some	50% public	There are recent plans, but no bank privatization so far.
India	1980-	36	4	None	90% public	No bank privatization so far.
Underdeveloped financial systems:						
Senegal	1978-	24	-	None	Mostly public	In 1989, government ownership of banks was reduced to less than 25 percent in each bank.
Ghana	1987-	16	-	None	Mostly public	There are plans but no bank privatization so far.

[illegible] Statistics and MCAP/GDP is the ratio of stock market capitalization to GDP from IFC's Emerging Market Data Base and are averages of [illegible] period. OECD figures are for 1991.

Appendix

Mexico - Financial Sector Reforms

	1988	1989	1990	1991	1992
I. Deregulation of the Financial Sector					
a. Ceilings on the issuance of banker's acceptances was removed.	X				
b. All interest rate controls and lending restrictions were abolished.		X			
c. Most restrictions on commercial bank activity were removed.		X			
II. Strengthening of Regulatory, Supervisory and Legal Systems					
a. Existing laws were amended to strengthen regulation and supervision.		X	X		
III. Reform of Monetary Control Instruments					
a. Reserve requirements were replaced by a 30% liquidity requirement which was later abolished.		X			
IV. Restructuring or Privatization of Financial Institutions					
a. Commercial banks were privatized.				X	X

Turkey- Financial Sector Reforms

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
I. <u>Deregulation of the Financial Sector</u>											
a. Removal of interest rate ceilings on bank deposits and loans	X										
b. Restrictions on foreign bank entry eased.	X										
c. Banks were allowed to expand into new areas of activity.	X										
d. Ceilings re-imposed on deposit rates.				X							
e. Istanbul Stock Exchange was re-opened.							X				
f. Deposit rates liberalized again (with informal CB intervention)									X		
II. <u>Strengthening of Regulatory, Supervisory, and Legal Systems</u>											
a. Capital Market Board (CMB) was established with the power to develop and regulate the securities markets.			X								
b. Deposit insurance established.				X							
c. New Banking Law was passed.						X					
d. Minimum capital base was established for new banks.						X					
e. BIS capital adequacy requirements were adopted.						X					
f. Limit of 10% imposed on lending to a single customer.						X					
g. Central Bank supervision and accounting standards of the banking system was improved.							X				
III. <u>Reform of Monetary Control Instruments</u>											
a. Limits on extension of credits from the Central Bank.			X								
b. Establishment of a money market and government securities auctions.							X				
IV. <u>Restructuring or Privatization of Financial Institutions</u>											
a. Failure of a leading money-broker precipitated the financial crisis.			X								
b. Several state-owned banks are slated for privatization.											X

Egypt - Financial Sector Reforms

	1991	1992	1993
I. <u>Deregulation of the Financial Sector</u>			
a. Capital account opened; interest and exchange rates liberalized.	X		
b. Foreign bank branches were authorized to engage in local currency business.		X	
c. Bank specific credit ceilings were removed.		X	
II. <u>Strengthening of Regulatory, Supervisory and Legal Systems</u>			
a. Minimum capital requirements are established and capital adequacy standards are adopted.		X	
b. Asset classification and provisioning guidelines introduced.		X	
c. Foreign currency exposure regulations issued and implemented.		X	
d. Loan exposure limits imposed at 25% of capital to single borrowers.		X	
e. Limits on equity holdings imposed.		X	
f. Deposit Insurance Fund was established.		X	
g. Central Bank powers were strengthened through amendments to the banking law.		X	
h. Bank supervision and audit practices were improved.		X	
III. <u>Reform of Monetary Control Instruments</u>			
a. Central Bank staff started training for the implementation of open market operations and indirect methods of monetary control.	X		
b. Outstanding ratios for reserve and liquidity requirements decreased.		X	
IV. <u>Restructuring or Privatization of Financial Institutions</u>			
a. Public banks were re-capitalized.		X	
b. Detailed audits of public and other commercial banks.		X	
c. Restructuring of problem banks started.		X	
d. One joint-venture bank (public-private) was privatized.			X

India - Financial Sector Reforms

	1992	1993
I. Deregulation of the Financial Sector		
a. Interest policy somewhat liberalized.	X	
b. Capital markets were deregulated and their taxation was reformed.	X	
c. Entry of private banks were allowed, guidelines for entry were issued.		X
II. Strengthening of Regulatory, Supervisory and Legal Systems		
a. Reserve Bank of India (RBI) introduced new guidelines for income recognition, asset classification, and provisioning requirements.	X	
b. BIS capital adequacy requirements are adopted with a phase-in period of three years.	X	
c. Securities exchange board of India started to function as an independent regulatory body.	X	
d. Legal steps are being taken to improve the loan collection mechanisms for banks.		X
e. To modernize supervisory practices a new supervisory body was established under the aegis of RBI.		X
III. Reform of Monetary Control Instruments		
a. Incremental 10% cash reserve ratio was eliminated and liquidity ratio was reduced.	X	
b. RBI introduced 364 day T-bill auctions.	X	
IV. Restructuring or Privatization of Financial Institutions		
a. Banks are allowed to raise private equity from capital markets while majority ownership will remain public.	X	
b. Government is prepared to recapitalize banks. 1993/94 budget includes an estimate of necessary funds.		

The Philippines - Financial Sector Reforms

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
I. Deregulation of the Financial Sector											
a. Functional distinctions between different financial institutions were removed. Commercial banks were allowed to operate as universal banks.	X										
b. Ceilings on long-term deposit rates were removed.	X										
c. Ceilings on long-term loan rates were removed.		X									
d. Ceilings on short-term deposit rates were removed.			X								
e. Ceilings on short-term loan rates were removed.				X							
II. Strengthening of Regulatory, Supervisory and Legal Systems											
a. Reform of the legal framework and bankruptcy laws and strengthening prudential regulations and their enforcement.								X			
III. Reform of Monetary Control Instruments											
a. Attempt to give primacy to T-bills in monetary operations.		X									
b. Reserve requirements were reduced.			X								
c. Rediscount rate adjusted in line with market rates.				X							
d. Access to rediscounts were rationalized.			X								
e. New liquidity window opened for "normal" needs.				X							
f. New central bank bills were issued.					X						
g. There was a shift to base money as intermediate target.					X						
IV. Restructuring or Privatization of Financial Institutions											
a. Number of financial institutions fell from 1216 in 1981 to 1025 in 1986 due to the 1981-86 financial crisis and subsequent restructuring, merger, and failures.		X	X	X	X	X	X				
b. The share of public banks in total banking assets was reduced from 28% to 1.4% in 1990.	X	X	X	X	X	X	X	X	X	X	X

Korea - Financial Sector Reforms

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1991
I. Deregulation of the Financial Sector											
a. Transactions in bonds and repos were formalized.	X										
b. Restrictions on scope of activities were eased.		X	X	X							
c. New entry of institutions was allowed.			X								
d. Deposit rates were partially liberalized to establish positive real rates.		X									
e. Credit ceilings abolished.			X								
f. Preferential interest rates abolished.			X								
g. Min/max interest rate ranges were introduced.					X						
h. Indirect portfolio investment by foreigners was allowed.		X	X	X	X	X					
i. Most bank lending rates were completely deregulated.										X	
j. Government announced a plan to completely deregulate money market and deposit rates by 1997.											X
II. Strengthening of Regulatory, Supervisory and Legal Systems											
a. Supervisory procedures reformed and focus strengthened.			X	X	X	X	X	X	X		
b. Over the counter market established for small and medium firms.								X			
c. Capital market laws were revised.								X			
III. Reform of Monetary Control Instruments											
a. Reserve requirements were lowered and unified.		X									
b. Reliance on directed credit was reduced.			X	X	X	X	X	X	X		
IV. Restructuring or Privatization of Financial Institutions											
a. Public banks were privatized.		X	X								
b. Bank debts were resheduled.				X	X	X	X	X	X		

Chile - Financial Sector Reforms

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
I. <u>Deregulation of the Financial Sector</u>													
a. Short-term money market rates were freed.	X												
b. Barriers to entry were lowered.		X											
c. Quantitative credit controls were removed.		X											
d. Interest rates were liberalized.		X											
e. Restrictions on scope of activities were eased.			X										
f. Foreign bank entry was allowed.			X										
g. Commercial banks were allowed to borrow abroad.			X	X	X								
II. <u>Strengthening of Regulatory, Supervisory and Legal Systems</u>													
a. Limits were imposed on bank lending to interrelated entities.								X					
b. Loan classification and provisioning rules were established.								X					
c. Measures to tighten bank supervision were approved.									X				
d. A banking law further strengthened prudential supervision.													X
III. <u>Reform of Monetary Control Instruments</u>													
a. Auctions of central bank credit and t-bills introduced.			X										
b. Reserve requirements were lowered and unified.					X								
IV. <u>Restructuring or Privatization of Financial Institutions</u>													
a. Commercial banks were privatized.		X	X	X									
b. Pension funds were privatized.							X						
c. 1981-83 financial crisis started with a run on a major bank. Authorities had to intervene and took over 8 institutions.								X					
d. Government took over 8 more institutions.										X			
e. Banks were re-privatized.												X	

Ghana - Financial Sector Reforms

	1987	1988	1989	1990	1991	1992
I. <u>Deregulation of the Financial Sector</u>						
a. Lending rates were partially liberalized.	X					
b. Interest rates were completely liberalized.		X				
c. Government controls over bank fees and charges were eliminated.				X		
d. Sectoral credit allocation targets were phased out.		X				
e. Bank specific credit ceilings were abolished.						X
f. New entry was allowed.				X		
g. Ghana stock exchange began operating.				X		
II. <u>Strengthening of Regulatory, Supervisory and Legal Systems</u>						
a. Banking law was amended to establish prudential lending limits and capital adequacy requirements. Uniform accounting and auditing standards were also instituted.				X	X	X
III. <u>Reform of Monetary Control Instruments</u>						
a. A T-bill auction was introduced.	X					
IV. <u>Restructuring or Privatization of Financial Institutions</u>						
a. Government re-structured banks.		X				
b. Government announced plans to privatize banks in 1993.		X				

Senegal - Financial Sector Reforms

	1989	1990
I. <u>Deregulation of the Financial Sector</u>		
a. Directed credits were reduced.	X	
II. <u>Strengthening of Regulatory, Supervisory and Legal Systems</u>		
a. Bank capital requirements were increased and prudential regulations were strengthened.	X	
b. Bank supervision was improved.	X	
III. <u>Reform of Monetary Control Instruments</u>		
IV. <u>Restructuring or Privatization of Financial Institutions</u>		
a. Banks were restructured. Some institutions were closed.	X	
b. Government ownership in each bank was reduced to less than 25%.	X	X

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